

CONSUMPTION AND GOVERNMENT DEBT IN HIGH DEFICIT COUNTRIES.  
IS TAX-DISCOUNTING STABLE OVER TIME?

Giuseppe Nicoletti

ABSTRACT

In the paper I investigate the extent of tax-discounting effects on private (non-durable and total) consumption in Italy and Belgium, two countries that have experienced dramatic changes in the trends of government debt and deficits in the post-war period. Using cointegration techniques, I estimate both a static (long-run) and a dynamic (error-correction) version of the consumption model. Estimates of the tax-discounting parameter are nil in the long-run relationship and quite large and significant in the dynamic specification, suggesting that tax-discounting behaviour is closely linked to the short-run adjustment components of aggregate consumption behaviour. A stability analysis of the dynamic model, focusing on the parameter of fiscal illusion, suggests that tax-discounting arises only in coincidence with sharp upward movements in the dynamics of public debt. The results are particularly robust for Belgium, where tax-discounting can be successfully modelled as a positive function of the debt-to-GNP ratio. These findings tend to confirm the cross-country evidence provided in Nicoletti (1988b) and suggest that Ricardian phenomena may be contingent on changes to government financing regimes, rather than being a stable characteristic of aggregate consumer behaviour deriving from the nature of individual preferences. When debt dynamics become explosive, a positive relationship between deficits and private saving may result from consumers' expectations of the increased tax burdens needed for a swift return to a stable policy course.